



HOUSE BUDGET COMMITTEE

Democratic Caucus

The Honorable John M. Spratt Jr. # Ranking Democratic Member

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Ten-Year Budget Surplus Estimates Are Unreliable

Dear Democratic Colleague:

Many Americans have questioned the wisdom of passing huge tax cuts which depend on \$5.6 trillion in ten-year CBO projected surpluses we may never realize. CBO itself concedes that its ten-year forecasts are speculative and could easily be wrong. If Congress enacts the \$2 trillion Bush tax cuts and we don't garner the large surpluses, Congress will face three bad choices: either let the budget slide back into the red, impose deep across-the-board cuts on key spending priorities like education and Medicare or raise taxes.

Attached is an excellent article from Sunday's New York Times explaining why there is a very real risk the projected budget surpluses could never materialize. The article cites three Wall Street economists who expect a plunge in tax revenue with the drop in stock market prices. One of the reasons for the growing budget surpluses over the past few years has been higher capital gains tax revenue as a result of the booming stock market. As investors have sold appreciated stock or exercised stock options, they pay large capital gains tax on their profits. But with the end of the market boom and the fall of stock prices, these Wall Street economists expect a drop in capital gains tax revenue and a resulting drop in the budget surplus. Mark Zandi, Chief Economist at Economy.Com, explains, "We've had years of stock-juiced surpluses at all levels of government. But a flat equity market will quickly weigh on government's good fiscal fortunes. Policy makers will be sorely disappointed and the economy's long-term performance will suffer." Robert Barbera, an economist at Hoenig & Company, explains, "estimates of revenues will be prove to be greatly exaggerated."

Congress should look at the experience of many state governments which cut taxes and launched new spending initiatives, all banking on growing budget surpluses. Now, with the economic slowdown, these same states are facing unexpected budget deficits which are forcing them to cut important state services.

This article and the experience of the states provide one more reason why Congress should move cautiously before passing huge tax cuts. A more responsible approach is to pass more affordable tax cuts and commit a significant portion of the remaining projected surpluses to pay down the debt and extend the solvency of Social Security and Medicare. Then, if the surplus projections prove too optimistic, we will be in a better fiscal position to address our nation's long-term needs, especially Social Security and Medicare.

Sincerely,

John M. Spratt, Jr.
Ranking Democratic Member

ECONOMIC VIEW

TOM REDBURN

Down Goes The Market. Is the Surplus Next?

WITH the nonpartisan Congressional Budget Office projecting a budget surplus of \$5.6 trillion over the next decade, Alan Greenspan, the Federal Reserve chairman, has taken to warning repeatedly that the federal government could end up paying off nearly all publicly held debt within a few years. That justifies a big tax cut, he argues, because otherwise Washington would accumulate so much excess cash that it would have no choice but to start buying big chunks of American companies.

My guess is he can stop worrying about that problem. Indeed, before too long, he could again be raising the specter of the return of budget deficits.

Lots of people have questioned the budget office's estimates of the surplus under current policies. The agency itself acknowledges that its projections — which lawmakers use to evaluate the impact of their budget plans — are subject to great uncertainty. Under normal circumstances, though, the budget office's figures are just as likely to be too low as they are to be too high.

But these are not normal circumstances. For nearly a decade, the United States has enjoyed not just a robust economy but also an extraordinary stock market boom. Strong growth, low unemployment and greater fiscal discipline have helped eliminate the old deficits. But it was the market, by generating tremendous taxable profits for investors and option-holding employees, that accounted for the lion's share of the unexpectedly large surpluses of recent years.

You may have noticed that the boom has stopped. So have three of the smartest economists I know — Mark Zandi, chief economist at Economy.com; Robert J. Barbera at Hoening & Company; and David Levine, who retired not long ago from Sanford C. Bernstein & Company.

O.K., it doesn't take a genius to see that the market has fallen. But all three experts have also come to the conclusion that the end of the boom will translate — probably not this year but soon afterward — into a big plunge in tax revenue from capital gains and other market-related sources of income. And that's worth paying attention to.

For example, Mr. Zandi, without changing any of the budget office's economic assumptions, estimates that instead of accumulating a 10-year surplus of \$5.6 trillion, the government will have no more than about \$2.9 trillion to spare for tax cuts and higher spending.

The Bush administration and leaders in Congress already plan to use that up and much more. If Mr. Zandi is right, those moves will wipe out all of the remaining surplus and plunge the federal budget back into the red.

In contrast to the budget office forecasts, Mr. Zandi looks at what might happen if the market stays about where it is for the next couple of years. He calculates that profits from capital gains and income from stock options will probably shrink by half within the next two or three years.

As a government entity, the Congressional Budget Office justifiably makes no effort to predict the market. Instead, it starts with last year's estimated level of capital gains realizations of \$652 billion and projects that they will only gradually fall as a share of the economy, stabilizing at over \$550 billion around mid-decade.

"C.B.O. is assuming these extraordinary capital gains revenues are here to stay," Mr. Zandi said. "That's fundamentally where they've got it wrong."

Mr. Barbera goes further. "Given current swelled coffers, a substantial tax cut will certainly be enacted," he wrote in a recent report, but "estimates of revenues will prove to be greatly exaggerated."

"In combination," he added, "less equity-market-driven tax receipts, slower growth and a large tax cut will prevent any flirtation with paying off U.S. Treasury debt."

Nobody is accusing Congressional estimators of deliberate error. Somebody has to produce an honest budget score sheet and the agency does the best job that it can.

"Producing a budget outlook is an art, not a science," said Melissa Merson, the budget office's communications director. "There's always an enormous degree of uncertainty, but we feel our forecast is very reasonable."

Still, if the critics are right, the consequences of relying on today's forecasts could be severe. And if the economy fails to recover soon, it would get a lot worse.

"I think most people are about to be very surprised," Mr. Levine said. "Should it prove true, which is possible, that we are entering a recession, the swing in the budget over a two-year period could easily reach \$400 to \$500 billion. Even without a recession, the surplus could easily disappear."

Mr. Zandi fears the worst. "We've had years of stock-juiced surpluses at all levels of government," he said. "But a flat equity market will quickly weigh on government's good fiscal fortunes. Policy makers will be sorely disappointed and the economy's long-term performance will suffer." □

